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ARTICLES

THE MORAL BASIS OF STATE CORPORATE LAW DISCLOSURE

*Eric A. Chiappinelli**

Since the 1930s, publicly held American corporations have been subjected to an increasingly elaborate federal system of mandatory disclosure. The merits of this system have garnered extensive scholarly commentary.¹ While these federal requirements apply only to public corporations, every corporation, public and private, is subject to the disclosure requirements of its state of incorporation. The most influential state in this regard is, of course, Delaware, but the Model Business Corporation Act (MBCA)² has also been influential. Both the Delaware act and the MBCA are far less extensive than the federal securities laws in the amount of information they require corporations to disclose. In contrast to the federal requirements, state-mandated corporate disclosure laws have received no sustained scholarly attention. Most commentators have analyzed state requirements only in connection with the adoption of the federal securities laws.

When one focuses on the federal and state disclosure schemes, the central puzzle is why federal disclosure is extensive while state disclosure is minimal. The federal government surely has the power to preempt state regulation but, as we will see, state-mandated corporate disclosure was minimal even before the federal requirements were first adopted. The difference in approach cannot, then, be explained by suggesting that an elaborate state scheme atrophied when federal regulation preempted it.

* Professor of Law, Seattle University School of Law. My thanks to my research assistant, Wendy Pursel Rocke. This Article grew out of my participation in a symposium on corporate disclosure and its impact on corporate morality and efficiency held at The Catholic University of America, Columbus School of Law. I am grateful also to Professor David A. Lipton for allowing me to speak at that Symposium.

1. See 1 LOUIS LOSS & JOEL SELIGMAN, SECURITIES REGULATION 172-213 (3d ed. 1998) (collecting much of the literature on the federal corporate disclosure system); see also Symposium, *Corporate Disclosure and Its Impact on Corporate Morality/Efficiency*, 48 CATH. U. L. REV. 1 (1998).

2. MODEL BUS. CORP. ACT (3d ed. & Supp. 1998/99).

The questions, "Why are the state and federal disclosure approaches so different?", and "What is the origin of these differences?", can be answered without resorting to normative evaluation. Such answers, however, would quickly be unsatisfying on their own. We need to analyze the normative implications of the philosophical differences between state and federal corporate disclosure requirements and ask whether these differences effectuate good social policy. Even more interesting is that the dominant explanation of the origin of these differences has a very strong moral dimension.³ More specifically, the traditional analysis suggests that the states have acted immorally by failing to impose greater disclosure obligations on their corporations.

The standard interpretation of this puzzle of corporate disclosure began in the late 1920s, before the federal government enacted disclosure regulations. In this standard interpretation, several prominent observers argued that American corporations were too secretive about their internal affairs. These observers believed that the solution was for the government to require corporations to disclose more detailed financial and operational information. The prominent observers believed that the states were both incapable and morally unwilling to impose the increased disclosure obligations. Accordingly, the experts argued for the federal government to compel disclosure.

In the wake of the 1929 stock market crash, these suggestions became the basis for the federal securities laws' disclosure requirements. Thus, even though state disclosure obligations remained moribund, the federal government imposed the appropriate solution on corporate America. Other interpretations, based on financial and corporate theory rather than on history, are consonant with the standard interpretation. That is, they focus on the federal regulations and either ignore state disclosure or consider the states rather reprobate.

The actual origin of the state disclosure requirements shows that the states acted ethically. The states rooted their approach in the division of power they imposed between shareholders and managers. The states created a system of corporate disclosure that recognized the differences in power between these two groups, especially the limited role of shareholders. The states' choice does not reflect, therefore, a lack of ethics or an inability to impose more elaborate standards. To the contrary, the states were powerful, rational, and moral in their decisions.

3. Throughout this Article I use the words "moral" and "ethical" interchangeably, although I realize that some commentators often regard the concepts as distinct from one another.

Today, calls for increased state corporate disclosure requirements are posited on two moral bases. The stronger basis asserts that more stringent requirements would result in the needed reform of corporate managers. The second basis argues that more stringent state disclosure requirements would facilitate the primary purposes of federal disclosure, which are the protection of potential investors and increased confidence in secondary capital markets. This Article argues that neither of these ends is likely to result from the imposition of additional state-mandated corporate disclosure.

This Article contends that current state corporate disclosure requirements are morally defensible both in their origins and in their current functioning. Today, as in the past, shareholders' primary duty is to select corporate directors. These directors, not the shareholders, set corporate policy. Although the directors are accountable to the shareholders, they are neither the shareholders' nor the corporation's agents. In other words, directors are not subject to the control of shareholders. Shareholders may either dismiss or reelect directors, but cannot instruct them directly on corporate policy. Appropriate corporate disclosure schemes should reflect this division of functions. This Article asserts that the current state disclosure schemes fulfill this task.

Part I of this Article describes current corporate disclosure obligations under Delaware law and the MBCA. Part II details the origins of the modern system of state-mandated corporate disclosure, describing both the traditional and the more nuanced and accurate version of that development. Part III considers the moral calls for increased state corporate disclosure obligations, and Part IV defends the morality of the current state system.

I. STATE CORPORATE DISCLOSURE REQUIREMENTS (WITH SPECIAL REFERENCE TO THE LAW OF DELAWARE)

A. *Delaware*

In Delaware, the short answer to the question, "What disclosure must a corporation make under state law?", is easy: "none." The more nuanced answer is: "next to none." The most salient disclosure requirement is the stockholder inspection right in Section 220 of the *Delaware Code*,⁴ which is triggered only when a stockholder makes a written demand on the corporation to inspect the corporation's books and records.⁵

4. DEL. CODE ANN. tit. 8, § 220(b)-(c) (1991 & Supp. 1998).

5. See *id.*

This requirement is further cabined by two provisions. First, only stockholders of record can demand inspection of a corporation's books and records.⁶ Beneficial holders, which includes shareholders who keep their stock in street name, must act through the record holder. Second, the requesting stockholder must demonstrate a "proper purpose . . . reasonably related to such person's interest as a stockholder."⁷

While the first of these restrictions is objective in that the corporation must look only to its own stock record book, the second is quite subjective despite a fair amount of case law.⁸ The indeterminacy of the second requirement leaves open the possibility that a corporation may unfairly refuse a stockholder's inspection request. This possibility most likely reduces the number of inspection requests and hence reduces the aggregate amount of information disclosed by corporations to their stockholders. One advantage afforded to stockholders is that once they demonstrate a "proper purpose," they may inspect the corporation's records regardless of whether they have additional, improper, purposes.⁹

Delaware's affirmative transaction disclosure obligations¹⁰ are primarily obvious, otiose, or illusory.¹¹ The most obvious obligation (and the least important to this Article's thesis) requires Delaware officers or directors to disclose all material non-public information they possess to persons with whom they trade when buying or selling the corporation's stock.¹²

6. *See id.* § 220(b).

7. *Id.*

8. *See, e.g.,* *Security First Corp. v. United States Die Casting & Dev. Co.*, 687 A.2d 563, 565, 566-71 (Del. 1997).

9. *See, e.g.,* *CM & M Group, Inc. v. Carroll*, 453 A.2d 788, 792-93 (Del. 1982) (noting that "once a proper purpose has been established, any secondary purpose or ulterior motive of the stockholder becomes irrelevant").

10. This Article, following traditional securities regulation conceptions, divides disclosure obligations into those that are triggered by a transaction and those that are triggered periodically. Two examples of common disclosure obligations triggered by a transaction include when a corporation issues stock and when a corporation's shareholders elect directors. An example of a periodic disclosure obligation is the Delaware state requirement that corporations must file a franchise tax report annually with the Secretary of State. *See* DEL. CODE ANN. tit. 8, § 502(a) (1991 & Supp. 1998). This report contains the location of the corporation's registered office, the name of its registered agent(s), its principal place of business, the names and addresses of all of its directors and up to two officers, and the corporation's capitalization. *See id.* Section 502 of the Delaware statute does not require Delaware corporations to include financial information or to send this report to their shareholders. *See id.*

11. *See generally* Lawrence A. Hamermesh, *Calling Off the Lynch Mob: The Corporate Director's Fiduciary Disclosure Duty*, 49 VAND. L. REV. 1087-1178 (1996) (a most wondrous article discussing Delaware's disclosure requirements).

12. *See, e.g.,* *Lynch v. Vickers Energy Corp.*, 383 A.2d 278, 279, 281-82 (Del. 1977)

When Delaware corporations solicit proxies from their shareholders, they have an obligation to disclose all material facts reasonably available.¹³ In the absence of a proxy solicitation, however, Delaware corporations do not need to disclose any information to their stockholders beyond the simple notice of shareholder meetings.¹⁴ This is an otiose requirement for public corporations because the Securities and Exchange Commission already mandates such disclosures.¹⁵

This disclosure obligation has force by virtue of state corporation laws only when non-public Delaware corporations choose to solicit proxies. Statistics illustrating how often such corporations solicit proxies are unavailable. Intuitively, however, such situations must be relatively rare because most non-public corporations can rely on the fact that their owners are sufficiently interested in corporate affairs to attend the annual shareholder meeting. At any rate, non-public corporations can rely on the holders of a majority of the shares to be present, which is the *Delaware Code's* only requirement for the stockholders to act at a meeting.¹⁶

Delaware law also contains a disclosure requirement that appears to have some substance, but which is illusory in the end. When corporations seek shareholder approval of any action, shareholders must be provided with all material information reasonably available.¹⁷ But this dis-

(dealing with a majority shareholder's disclosure of non-public information to minority shareholders).

13. See *Stroud v. Grace*, 606 A.2d 75, 85, 87 (Del. 1992).

14. See *id.* at 85-86 (rejecting a duty of complete candor as to information provided in pre-shareholder meeting notices). Delaware law provides that:

Whenever stockholders are required or permitted to take any action at a meeting, a written notice of the meeting shall be given which shall state the place, date and hour of the meeting, and, in the case of a special meeting, the purpose or purposes for which the meeting is called.

DEL. CODE ANN. tit. 8, § 222(a) (1991). But see *Lynch*, 383 A.2d at 279, 281-82 (stating the disclosure of all germane information to minority shareholders as required in non-proxy votes).

15. See 17 C.F.R. § 240.14a-13(a) (1999) (requiring reporting companies to disclose a substantial list of various types of information of their proxies). SEC regulations require companies to disclose vast amounts of information about their officers and directors. See *id.* § 240.14a-101 (items 7 & 8 of information required in a proxy statement). If a reporting company plans to hold a meeting during which shareholders will elect directors, SEC Rule 14a-3(b) requires the company to include an annual report to its security holders in conjunction with its solicitation of proxies. See *id.* § 240.14a-3(b). This annual report to security holders must include substantial information about the company's business, its financial condition, and the results of its operations. See *id.* §§ 240.14a-3(b)(1), (5)(ii), & (7).

16. See DEL. CODE ANN. tit. 8, § 216(1) (1991) (stating that unless the certificate of incorporation or bylaws state otherwise, a majority of the shares entitled to vote in person or by proxy shall constitute a quorum at a meeting).

17. See *Stroud*, 606 A.2d at 84.

closure can be made at the meeting itself and shareholders who do not attend have no right to have that disclosure sent to them.¹⁸ In the absence of a shareholder vote, Delaware corporate shareholders are not entitled to any information about the finances or affairs of corporations in which they invest.¹⁹ Furthermore, shareholders have no right to ask questions at shareholder meetings.²⁰ Management may refuse to entertain shareholder questions, and may even cut shareholders off when they are speaking.²¹

This disclosure requirement undoubtedly seems important to the shareholders who attend a stockholder meeting. Justice Holland of the Supreme Court of Delaware recently validated this view when he stated that the disclosure obligation requires directors "to provide shareholders with all information that is material to the action being requested and to provide a balanced, truthful account of all matters disclosed in the communications with shareholders."²² Additional Delaware case law reinforces this interpretation. In 1997, the Supreme Court of Delaware held, in *Loudon v. Archer-Daniels-Midland Co.*,²³ that shareholders have a right to full disclosure even in electing an uncontested slate of directors.²⁴ This holding has important implications because all corporate power is ultimately vested in the board of directors.²⁵ Director elections, then, even when uncontested, presumably trigger a corporation's obligation to disclose every fact material to the corporation, so shareholders can make informed decisions when casting or withholding their votes. Delaware corporations must abide by this rule despite having no obligation to disclose any of the required information in writing, in advance of the meeting,²⁶ or to shareholders who do not attend the meeting, if the directors

18. See *id.* at 87 (providing that Delaware law does not require the (1) purposes of or (2) matters to be discussed at a shareholder meeting to be disclosed prior to the meeting itself).

19. See *Malone v. Brincat*, 722 A.2d 5, 11 (Del. 1998).

20. See *Loudon v. Archer-Daniels-Midland Co.*, 700 A.2d 135, 146 (Del. 1997) (noting that complainant did not prove a shareholder right to ask a question).

21. See *id.* at 139 (describing a situation where management abruptly dismissed any efforts by stockholders to comment or question the corporation's current affairs).

22. *Malone*, 722 A.2d at 12.

23. 700 A.2d 135 (Del. 1997).

24. See *id.* at 144.

25. See DEL. CODE ANN. tit. 8, § 141(a) (1991) (noting that, unless otherwise specified, the business and affairs of every corporation organized under this chapter shall be managed by the board of directors).

26. See *Stroud v. Grace*, 600 A.2d 75, 85 (Del. 1992) (emphasizing that Delaware law merely requires notice of a shareholder meeting).

choose not to solicit proxies.²⁷

This requirement is truly stunning because it has only the most tenuous connection to the theories of director legitimacy and shareholder franchise. A shareholder's right to vote for directors is rooted in two concepts: (1) the division of power between shareholders and the board, and (2) the consent of the shareholders that these particular people serve as directors to whom all corporate power is given.²⁸

Requiring full disclosure in the director election setting seems, on the surface, to be a logical concomitant to this understanding of the importance of the franchise. Typically, however, directors run unopposed. In such instances, full disclosure seems merely illusory in its protection of shareholder voting power.

The limited range of shareholders' responses shows the disconnection between disclosure and the franchise in the uncontested election setting. First, a shareholder who, after full disclosure, deems the proposed directors to be unacceptable, can withhold his or her votes. Under Delaware law, however, withheld votes do not affect the corporation, except in the rarest of circumstances, because directors are elected by "a plurality of the votes of the shares present."²⁹ Given the legitimacy of advance-notice bylaws, directors can effectively prevent nominations from the floor, and hence any shareholder's vote would be sufficient to elect the proposed slate.³⁰

Alternatively, shareholders who are determined to stymie director elections could refuse to attend. On occasion, this tactic might prove effective. Delaware law states that no fewer than one-third of the shares entitled to vote shall constitute a quorum at a shareholder's meeting for action to be taken.³¹ In the overwhelming number of instances, however, the controlling faction will control at least one-third of the votes. It would be a highly unusual, though not impossible, setting in which dis-

27. *Cf. id.* (noting that additional disclosure is not mandated "in the absence of a proxy solicitation"). "We require proxy voters to have all material information reasonably available before casting their votes." *Id.* at 87.

28. *See Blasius Indus., Inc. v. Atlas Corp.*, 564 A.2d 651, 659 (Del. Ch. 1988). Shareholder voting for directors is the "ideological underpinning upon which the legitimacy of directorial power rests." *Id.* at 659. "[I]t is critical to the theory that legitimates the exercise of power by some (directors and officers) over vast aggregations of property that they do not own." *Id.*

29. DEL. CODE ANN. tit. 8, § 216(3) (1991). In Delaware, a shareholder can only defeat the election of a slate of directors by withholding his or her votes if his or her withheld votes are the only ones present in person or by proxy and entitled to vote on the election of directors. *See id.* The likelihood of this occurring is virtually nil.

30. *See Stroud*, 606 A.2d at 95-96.

31. *See DEL. CODE ANN. tit. 8, § 216* (1991 & Supp. 1998).

satisfied shareholders controlled more than two-thirds of the shares and yet did not propose an alternative slate of directors. Consequently, this Delaware rule that appears to guarantee disclosure for shareholders is instead illusory.

Another rule that appears to protect shareholders but turns out to be an illusion allows shareholders to recover damages for disclosure violations. The Delaware Supreme Court has clearly held that shareholders may prevail in a disclosure violation action simply by showing the materiality of the misstatement or omission.³² As a practical matter, however, damages in excess of a nominal amount are not a serious remedy for failure to disclose.³³

B. The Model Business Corporation Act

The Model Business Corporation Act (MBCA),³⁴ which twenty-four states have adopted,³⁵ provides shareholders with more detailed inspection rights than Delaware law. Shareholders may inspect and copy the following corporate documents without showing a proper purpose: (1) basic constituent documents, (2) the names of the directors and officers, (3) three years' worth of corporate actions, and (4) three years' worth of financial statements.³⁶ Shareholders who act in good faith and show a proper purpose may inspect certain records reasonably related to that purpose.³⁷ Shareholders may also inspect the list of shareholders two days after the corporation sends notice of an upcoming meeting to its shareholders.³⁸

Although the MBCA requires corporations to notify their shareholders about shareholder meetings, this statute does not otherwise mandate affirmative transactional disclosure obligations upon corporations in connection with shareholder actions. In two types of situations, however, corporations must inform their shareholders of corporate actions even though shareholders are not required to act. Specifically, a corporation must tell its shareholders when it indemnifies a director in connection with a derivative suit.³⁹ A corporation must also notify its shareholders

32. See *Malone v. Brincat*, 722 A.2d 5, 12 (Del. 1998).

33. See *id.* at 12 & n.27.

34. See MODEL BUS. CORP. ACT (3d ed. & Supp. 1998/99).

35. See *id.* at xxvii.

36. See *id.* §§ 16.02(a), 16.01(c), (e).

37. See *id.* § 16.02(b), (c)(1).

38. See *id.* § 7.20(b).

39. See *id.* § 16.21(a).

when it issues shares for promissory notes or future services.⁴⁰ The MBCA further requires some periodic disclosure, as corporations must annually send basic financial information to their shareholders.⁴¹ This requirement is more convenient for shareholders than the MBCA's disclosure obligations for other information (i.e., financial), which only require corporations to make such information available at their principal offices.⁴²

II. ORIGIN OF THE MODERN SCHEME

A. The Received Tradition

From William Z. Ripley in 1927, to the contemporary Joel Seligman, the standard interpretation of the origins of the current state corporate disclosure system has been consistent.⁴³ According to this story, the states had been ineffective in providing useful disclosure to shareholders and generally had been complicit with large corporations. The federal government, therefore, stepped in to provide needed regulations, firm yet fair, through the Securities Act of 1933⁴⁴ and the Securities Exchange Act of 1934.⁴⁵ The upshot of this interpretation is that state disclosure obligations have become irrelevant when they are not simply immoral. The federal government arrogates the moral high ground by rescuing the capital markets, and hence America, by restoring and ensuring market integrity.

By the late 1920s, the American economy reached its highest levels ever and seemed headed for even greater heights.⁴⁶ Against this background, William Z. Ripley, a Harvard professor of political economy, published his famous critique of corporate affairs, *Main Street and Wall*

40. See *id.* § 16.21(b).

41. See *id.* § 7.05(a)–(b).

42. See *id.* §§ 7.20(b), 16.02(a).

43. See WILLIAM Z. RIPLEY, *MAIN STREET AND WALL STREET* (1927); JOEL SELIGMAN, *THE TRANSFORMATION OF WALL STREET: A HISTORY OF THE SECURITIES AND EXCHANGE COMMISSION AND MODERN CORPORATE FINANCE* (1982) [hereinafter SELIGMAN, *TRANSFORMATION*]; Joel Seligman, *A Brief History of Delaware's General Corporation Law of 1899*, 1 DEL. J. CORP. L. 249 (1976) [hereinafter Seligman, *Brief History*]. See generally 1 LOSS & SELIGMAN, *supra* note 1, at 29-225; MICHAEL E. PARRISH, *SECURITIES REGULATION AND THE NEW DEAL* 1-41 (1970).

44. 15 U.S.C. § 77 (1994).

45. 15 U.S.C. § 78 (1994).

46. See generally JOHN BROOKS, *ONCE IN GOLCONDA: A TRUE DRAMA OF WALL STREET 1920-1938* 65-85 (1969).

Street.⁴⁷ The most pervasive problem in regulating corporations was, according to Ripley, "impublicity."⁴⁸ Ripley argued that state efforts to compel disclosure would prove to be utterly futile.⁴⁹ More importantly, he stated that the possibility of future state regulation promised very little.⁵⁰ The root of this failure originated from the states' lack of morality, which contributed to their failure to adopt and enforce appropriate disclosure legislation.⁵¹ Ripley commended the New York Stock Exchange (NYSE) for trying to raise the morality of corporate disclosure through its listing standards.⁵² The NYSE's attempts, however, generated limited effects because the NYSE held suzerainty over few of the nation's corporations.⁵³ Ripley therefore concluded that federal regulation provided the only solution.⁵⁴

Ripley believed that three groups were entitled to information on corporations: (1) shareholders, (2) the government, and (3) the general public.⁵⁵ But Ripley rejected two salient theoretical grounds to support this entitlement view, one of which Ripley treated as a *non sequitur*.⁵⁶ Ripley railed against the other theoretical ground, which argued that shareholders are entitled to disclosure because they are the ultimate owners and called this the democratization of control argument.⁵⁷ In Ripley's view, this argument could not support any disclosure requirements

47. See generally RIPLEY, *supra* note 43.

48. *Id.* at 156-57, 208.

49. See *id.* at 218.

50. See *id.* at 217.

51. See *id.* ("The pressure of local opinion in the case of important concerns can only be overcome by exercise of these powers [i.e. legislation to compel disclosure] from a distance."); see also *id.* at 217-18 (explaining that "these local [Blue Sky] commissions . . . almost inevitably become apologetic or complacent when confronted by serious situations in important close-by going concerns"); *id.* at 219 (concluding that "as to state activity we are confronted, as always, with the lamentable diversity of morale").

52. See *id.* at 220.

53. See *id.* at 210, 213. "[S]ince 1920, under the leadership of the New York Stock Exchange, the improvement in morale has been genuine and noteworthy. The influence of it has not yet, however, fully permeated the precincts of the State House at Albany." *Id.* at 220.

54. See generally *id.* at 220-22. Ironically, Ripley did not see a need for new legislation; the Sherman Act, as amended by the Federal Trade Commission Act, gave the federal government all of the power it needed to compel adequate corporate disclosure. See *id.* at 222-23.

55. See *id.* at 165.

56. See *id.* at 165-66. Ripley noted the concession theory of the corporation, under which states have various rights against corporations because states are the entities that permit the organizers to incorporate. See *id.* Ripley never suggests any connection between the franchise and disclosure. See *id.*

57. See *id.* at 168-69.

because the practicalities did not support the theory. Shareholders may own a corporation in theory, but in practice, shareholders tend to be apathetic and, largely, incompetent to assess any corporate disclosures.⁵⁸ Required corporate disclosure may advance sound management, but only because experts mediate to the shareholders, but not because the corporation, as the servant of its ultimate owners, has made disclosures to the shareholders.⁵⁹

Ripley ultimately grounded his argument for required corporate disclosure on instrumental considerations of social policy. The central virtue of corporate disclosure, which Ripley called its ultimate defense, is that disclosure will facilitate an accurate market price.⁶⁰

It is important to appreciate that Ripley was more concerned with public rather than private virtues. In other words, Ripley was more concerned with preserving general or diffuse societal virtues rather than relatively well-defined or specific virtues. Ripley illustrates this concern through his instrumental arguments in favor of disclosure, which were societal rather than specific in nature. For example, Ripley argued that disclosure would facilitate the virtues of national economic efficiency while allowing the government to effect more easily the antitrust laws.⁶¹ Ripley also believed that disclosure would help to reinforce rational tax policy and smooth national labor relations.⁶²

Ripley viewed the stock market as a public, societal asset rather than one that primarily benefits individuals. In his view, the anonymity of the modern securities market had replaced traditional, individualized, face-to-face, transactions.⁶³ Ripley noted that the number of individual stockholders increased radically after World War I. This augured for a societal interest in corporations, the market for their shares, and ultimately for required corporate disclosure. Previously, the conception of

58. *See id.* at 169.

59. *See id.*

60. *See id.* at 169-70.

Must one reiterate that . . . the registration of a fair market price, consonant with the real earning power of the company, is a matter of daily and universal importance to every shareholder who may have occasion to buy or to sell securities? This instance is worth citing just to drive home the main defense of the proposed reform.

Id. at 219.

61. *See id.* at 166-67.

62. *See id.* at 168.

63. *See id.* at 206. "Among these influences [that encourage speculation rather than investment are] . . . the substitution of an open and impersonal market for narrow, over-the-counter, and revealed transactions . . ." *Id.*

shareholding had been almost entirely atomized and specific.⁶⁴ Because corporate disclosure effects a reliable market price, neither the current shareholders, who may or may not be interested in selling shares, nor corporations seeking to issue more shares, benefit from such disclosure as much as the public at large, which may buy shares from the corporation itself or its current shareholders.

What is the connection between Ripley's societal impetus for disclosure and the morality of that disclosure? It is that the remedy for "impurity" will be national in scope. Furthermore, the states cannot and will not implement effective remedies in part because the states lack what Ripley calls morale.⁶⁵ "[T]he most obvious, the simplest, the most effective remedy of all" is for the Federal Trade Commission to exercise its statutory powers to require disclosure by most corporations engaged in interstate commerce.⁶⁶

Let the right sort of [FTC] appointments be made; or let the word go forth that the Federal Trade Commission is henceforward to address itself vigorously to the matter of adequate and intelligent corporate publicity, and, taken in conjunction with the helpful agencies already at work, the thing is as good as done.⁶⁷

Ripley argued that the states cannot effectively enforce a system of corporate disclosure for several reasons.⁶⁸ First, substantive state disclosure rules would vary from one state to the next, and one state could not enforce its rules in another state, thereby thwarting any effective disclosure scheme.⁶⁹ Second, the states would be reluctant to enforce regulations against local businesses.⁷⁰ Third, state disclosure regulations, to the extent they are conceptually of a piece with the blue sky statutes,⁷¹ would

64. *See id.* at 156 (contending that "[t]he sudden advent of widespread popular ownership of corporations since the [first] World War has created entirely new circumstances and conditions in the business world").

65. *See id.*

66. *See id.*

67. *Id.* at 228. Ripley suggested two other partial remedies. First, the NYSE should continue raising its disclosure requirements. *See id.* at 210. The obvious limitation is that the NYSE only has control over corporations that are listed on it. *See id.* at 213. Second, shareholders should organize themselves, much as workers unionized, and work collectively toward increased corporate disclosure. *See id.* at 214. Even Ripley is unsure about the practicality of these solutions. *See id.* at 214-16.

68. *See id.* at 217-21.

69. *See id.* at 217-18.

70. *See id.*

71. *See* LOSS & SELIGMAN, *supra* note 1, at 34-41.

be aimed at preventing fraud rather than facilitating a market price.⁷²

Infused through these concerns is Ripley's opinion that the states are simply not moral enough to impose effective mandatory disclosure on their domestic corporations.⁷³ States would succumb to the pressure of local opinion, as they did with attempts to prevent child labor.⁷⁴ The states would become apologetic and complacent.⁷⁵ Apparently, Ripley believed that the states' moral resolve is as lax in corporate matters as it is in the area of private morals.⁷⁶ Finally, given the equal power of each state, one state's higher standard of morality would simply drive the problem to other states.⁷⁷

The most influential corporate commentators in the first half of the twentieth century, Adolf Berle and Gardiner Means, also saw a dichotomy between the public, societal aspects of the securities market, and the private, specific aspects of corporate law regulating the relations between corporations and shareholders.⁷⁸ Berle and Means, like Ripley, concentrated their attention on the societal need for corporate disclosure to facilitate the societal virtue of effective securities markets.⁷⁹ They were principally concerned with disclosure to prospective buyers, either upon the initial issuance of shares, or in the secondary market.⁸⁰ They were

72. See RIPLEY, *supra* note 43, at 219.

73. See *id.* at 217-18.

74. See *id.* at 217.

Heartbreaking experience in enforcement of factory legislation by local authority is of record. "If I were to attempt to execute the present law (as to child labor), this village would be too hot to hold me," was the way one of the Connecticut school visitors put it at the time.

Id.

75. See *id.* at 217-18.

76. See *id.* at 219 ("Delaware and Nevada, one specializing in incorporation and the other in divorce, have thus far refrained from enactment of any protective legislation of the sort.").

77. See *id.* at 219-20 (observing that "then, again, as to state activity we are confronted, as always, with the lamentable diversity of morale."); see also *id.* at 220 (quoting an anonymous New York Deputy Attorney General as saying that "[a] general housecleaning has ensued in the state of New York, and an exodus of undesirables to Florida, Boston, Canada, and New Jersey").

78. See generally ADOLF A. BERLE, JR. & GARDINER C. MEANS, *THE MODERN CORPORATION AND PRIVATE PROPERTY* (1932).

79. See *id.* at 10-46. "[The investment bankers' pre-offering disclosure document] serves a double function. It is the prospectus designed to attract buyers for the security. It is also the bankers' disclosure of information upon which the market is expected to appraise the securities." *Id.* at 301.

80. See *id.* at 301. Berle & Means argue that "[i]t becomes necessary, therefore, to consider . . . first, the relation of the bankers' disclosure towards *buyers* [directly from the investment banker] . . . and second, the relation of the disclosure towards *persons* . . . who

not concerned with corporate disclosure to existing shareholders except to the extent that such disclosure induced confidence in the prevailing market price or effected a more accurate market price.⁸¹ This lack of concern was based on Berle and Means' belief that stockholders are not as interested in corporate governance as they are in the economic qualities of their investments.⁸² Berle and Means gave only a glancing mention to state-mandated corporate disclosure laws because, like Ripley, they believed that state corporations law did not hold much hope of greatly increasing social benefit.⁸³ Unlike Ripley, however, Berle and Means did not dwell on this argument.⁸⁴

With the exception of an occasional reference,⁸⁵ Berle and Means did not consider whether state law disclosure systems were effective and did not opine on whether the states' disclosure systems derived from a lack of morality. Commentators should not attribute this lack of an explicit moral judgment by Berle and Means to an inattention to state corporations laws generally. To the contrary, Berle and Means devoted much of their book to a rather detailed description of the private property aspects of shareholding, which is firmly rooted in state corporate statutes.⁸⁶ Observers should also not attribute this lack of moral judgment of the states to Berle and Means' inattention to morality itself. The book deals, quite explicitly, with the potential for corporate disclosure to manipulate stock prices, and with the questionable morality of corporate managers who may decide to manipulate disclosure for such purpose:

Disclosures made to the market, however, in theory are merely

buy in the open market" *Id.* (emphasis added).

81. *See id.* at 317-19. "All of these [forms of corporate disclosure] relate to information which . . . would not otherwise be easily or accurately discovered by the market." *Id.* at 317.

It is interesting to note how little relation this variety of disclosure bears to the disclosures required by law [N]o state requires disclosure of the facts considered usual in the normal open market situation. It will be noticed that . . . the underlying assumption is that such information must be considered as a private matter, of interest only to its shareholders; and even in that regard limits in the extreme the information which the corporate management must make available, even to its own shareholders.

Id. at 318.

In addition, "[t]here are no legal requirements necessitating disclosure of information to creditors such as bondholders." *Id.* at 319.

82. *See id.* at 321 (observing that "[a] share of stock is primarily a capitalized expectation, valued by an open market appraisal of the situation existing in the corporation and the industry").

83. *See id.* at 121.

84. *See id.* at 287.

85. *See, e.g., id.* at 318.

86. *See generally id.* at 127-288.

informative. If made with the intention of inducing action, they may easily be improper from a strictly ethical point of view, save where the circumstances are peculiar; since it is not the business of the management to create market movements It is extremely dangerous for a management to make disclosures with the direct object of inducing market action. To do so may imply either the highest ethical intent of the managers, or the most sordid motives of personal gain⁸⁷

This basic conception of the morality of corporate disclosure requirements in the first quarter of the twentieth century became the standard history of the impetus for the Securities Act of 1933. In this version of history, after the 1929 stock market crash, the federal government needed to impose a corporate disclosure regime because the states' laws were too lenient and no other mechanisms existed to effect corporate disclosure.⁸⁸ This history often minimizes, however, the sea of change that Felix Frankfurter, Benjamin Cohen, Thomas Corcoran, and James Landis brought about in drafting the original Securities Act.⁸⁹ Any push for more stringent state-imposed corporate disclosure requirements quickly became irrelevant because the federal government established a system that was much more efficient than state systems could ever have been.

Shifting our attention away from state corporate laws as simply the precursors to federal securities laws and back to state corporate laws on their own terms, the standard interpretation declares that the states were not simply inefficient, but were genuinely immoral in creating lax disclo-

87. *Id.* at 320, 325.

88. *See* SELIGMAN, TRANSFORMATION, *supra* note 43, at 39-41.

Roosevelt committed himself to the long-held populist and progressive goal of superseding lax state corporation laws with more stringent federal standards. His securities policy was an attempt to remedy the weaknesses in the four bodies of state and private rules then in effect [state corporate laws, state blue sky laws, the NYSE regulations, and the accounting profession's standards], which cumulatively failed to minimize fraud or unfairness in the initial sale of corporate securities.

Id. at 42; *see also* LOSS & SELIGMAN, *supra* note 1, at 119-121.

89. *See* SELIGMAN, TRANSFORMATION, *supra* note 43, at 60-64.

The Securities Act of 1933 was a conservative response to the economic crisis known as the depression Only by returning to the historical moment when the 1933 Securities Act was fashioned can one fully appreciate how modest the disclosure philosophy was in aim, how comparatively little effect on the economy it was intended to have, and how fortuitous were critical aspects of its adoption.

Id. at 39-40; *see also* PARRISH, *supra* note 43, at 42 ("The principal architects and supporters of the 1933 Federal Securities Act were political moderates who labored against the counselors of deliberate procrastination and the advocates of rash innovation."); DONALD A. RITCHIE, JAMES M. LANDIS: DEAN OF THE REGULATORS 43-61 (1980).

sure laws. Joel Seligman applied the criticism exemplified by Ripley's work and used it to insinuate this idea.⁹⁰ He particularly excoriated Delaware for its pro-management corporations statute of 1899; its court decisions, especially those from the late 1950s, that further limited shareholder protections from management overreaching; and its corporations statute of 1967.⁹¹ In all fairness, Seligman did not address corporate disclosure specifically. He did advert, however, to the relationship between shareholder and management power,⁹² of which corporate disclosure is emblematic. Throughout, Seligman suffused a broad judgment that Delaware and other leading corporations law states have, in the twentieth century, acted immorally in regulating their corporations.⁹³

This standard interpretation notes that during the "golden age" of American corporation law, the Jacksonian era, states replaced special charters with general incorporation laws. These statutes represented an advance over the previous special, ad hoc, charters that state legislatures had been granting because they largely eliminated the monopoly privileges that such charters frequently contained.⁹⁴ This virtuous world ended, however, with the explosion of large, multi-state business entities after the Civil War. Those entities became constrained by state corporate law systems, in particular by the common law of corporations, which made multi-state operations illegal.

In the 1890s, New Jersey entered the "charter-mongering" business, enacting a "lax" corporate disclosure law.⁹⁵ Seligman seems to have believed that a Gresham's Law⁹⁶ of corporate regulation existed because he reports that "social Darwinism was stood on its head"⁹⁷ and that, while muckraking journalists and other commentators complained about New Jersey,⁹⁸ other states believed they had to adopt New Jersey's approach to chartering corporations or risk losing important tax revenues.⁹⁹

Delaware followed New Jersey's lead by enacting its 1899 incorpora-

90. See generally Seligman, *Brief History*, *supra* note 43.

91. See *id.* at 253, 271-73, 279, 282, 284-85.

92. See *id.* at 258.

93. See *id.* at 283-86.

94. See *id.* at 257.

95. See *id.* at 264-65.

96. Thomas Gresham, "financial agent, expert, and wizard of Queen Elizabeth" in the 16th century, formulated the proposition that "bad money drives out good," which is known today as "Gresham's Law." JURG NIEHANS, *A HISTORY OF ECONOMIC THEORY* 21 (1990).

97. Seligman, *Brief History*, *supra* note 43, at 269.

98. See *id.* at 268.

99. See *id.* at 269-70 (listing the types of laws states adopted during this era).

tion statute, and has been the preeminently lax state since New Jersey's brief period of reform in 1913 allowed other states to step to the fore.¹⁰⁰ The Delaware judiciary abets the Delaware General Assembly in this enterprise by systematically filling the interstices in the statute with decisions that reinforce the regulation's laxity.¹⁰¹ This view is certainly not Seligman's alone, although he is the most nuanced proponent. Another commentator, William Cary, has been the most often cited proponent of the belief that state corporations laws are immoral. Cary, in a famous 1974 *Yale Law Journal* article, characterized the notion of states' competition for corporate charters as a race for the bottom.¹⁰²

B. Other Interpretations

The standard interpretation is not the only interpretation. The law and economics movement, in particular, has considered disclosure requirements and the role of states versus the federal government. Law and economics scholars share the standard interpretation's instrumental views of disclosure—that disclosure is important only to the extent that it facilitates the market for securities, and that the states are incompetent to implement appropriate disclosure rules.

Judge Frank H. Easterbrook and Dean Daniel R. Fischel have been leading theorists in the law and economics field over the past generation.¹⁰³ In their most sustained discussion of corporate disclosure, they measured disclosure rules' efficacy by determining whether the rules made the securities trading markets more economically efficient.¹⁰⁴ Easterbrook and Fischel were not concerned with the corporate governance effects of disclosure as a potential for shareholder monitoring of management, or as a potential for non-economic yet socially desirable corporate actions. They argued that the only appropriate measure of social utility is whether shareholders buy or sell stock at prices reflecting all

100. See *id.* at 270-71.

101. See *id.* at 283-84.

102. See William L. Cary, *Federalism and Corporate Law: Reflections Upon Delaware*, 83 YALE L.J. 663, 668-70, 672 (1974). For a discussion on the article's fame and influence, see Fred R. Shapiro, *The Most-Cited Articles from the Yale Law Journal*, 100 YALE L.J. 1449, 1462 (1991). See also Lucian Arye Bebchuk, *Federalism and the Corporation: The Desirable Limits on State Competition in Corporate Law*, 105 HARV. L. REV. 1435, 1444-45 (1992) (explaining Cary's "race for the bottom" theory).

103. See generally FRANK H. EASTERBROOK & DANIEL R. FISCHEL, *THE ECONOMIC STRUCTURE OF CORPORATE LAW* (1991).

104. See *id.* at 311 ("The principal benefit asserted for mandatory disclosure is that investors will make more money Society gains with investors, because wise investment means efficient matching of funds with projects.").

information available about the issuer and in transactions with low costs.

The law and economics theory asks whether the states or the federal government are the more appropriate regulator of corporate disclosure, assuming that regulation is needed to supplement or supplant the market for information. Easterbrook and Fischel believed that the states are engaged in a competitive market to provide optimal disclosure rules. State regulation would improve corporate disclosure because the coercive nature of governmental regulation eliminates the collective action and free rider problems of a free market for disclosure.¹⁰⁵ State competition for optimal regulation schemes is obviously lacking where the federal government imposes a single scheme unchecked by market forces.¹⁰⁶ Despite this fact, Easterbrook and Fischel believed that the states are not competent, primarily on moral grounds, to provide better disclosure than the federal government.¹⁰⁷

Another alternative to the standard interpretation is the mediating hierarchy model of corporate law, sometimes called the team production approach.¹⁰⁸ The core of this approach is that the corporate enterprise is

105. *See id.* at 295-96.

106. *See id.* at 303. Easterbrook and Fischel contend that "[r]egulation is more failure-prone than markets, because there are few automatic forces that correct regulation gone awry. The regulatory system lacks a competitor, and the very fact of regulation often suppresses the information necessary to detect regulatory failure." *Id.*

107. *See id.* at 300-02. Easterbrook and Fischel's morality argument is that states can externalize the cost of disclosure for their citizens by requiring, either legislatively or judicially, disclosure or damages for nondisclosure, of information that resident investors would like but which is not produced under an optimal state regulation system. *See id.* at 301. In effect, state collective action problems may arise when states opportunistically—immorally—exploit foreign corporations. *See id.* *Sadler v. NCR Corp.*, 928 F.2d 48 (2d Cir. 1991), decided after Easterbrook and Fischel wrote their book on this topic, illustrates just such danger. Only the federal government can eliminate the potential for state exploitation by imposing a single regulatory scheme. *See Easterbrook & Fischel, supra* note 103, at 302. A collateral argument that Easterbrook and Fischel made is that liability for violating state disclosure regulations is inherently uncertain *ex ante*. *See id.* This is because issuers' costs of capital increase suboptimally because the potential liability in securities litigation is enormous. *See id.* The federal government's system of pre-disclosure oversight reduces the *ex ante* risk and, overall increases investor wealth. *See id.* at 307-08; *see also* Bebchuk, *supra* note 102, at 1444-48, 1490-94.

108. This approach originates in Margaret M. Blair & Lynn A. Stout, *A Team Production Theory of Corporate Law*, 85 VA. L. REV. 247 (1999) [hereinafter Blair & Stout, *Team Production*]. Recently, *The Journal of Corporation Law* published a symposium of articles on this topic. This symposium included: Margaret M. Blair & Lynn A. Stout, *Team Production in Business Organizations: An Introduction*, 24 J. CORP. L. 743 (1999) [hereinafter Blair & Stout, *Introduction*]; John C. Coates IV, *Measuring the Domain of Mediating Hierarchy: How Contestable are U.S. Public Corporations?*, 24 J. CORP. L. 837 (1999); Viet D. Dinh, *Codetermination and Corporate Governance in a Multinational Business Enterprise*, 24 J. CORP. L. 975 (1999); Melvin A. Eisenberg, *The Conception That the Corporation Is a Nexus of Contracts, and the Dual Nature of the Firm*, 24 J. CORP. L.

a team production: more than one person is required, at least some of the inputs are team-specific, and the profits are not easily attributable to any particular person's efforts.¹⁰⁹ From this economic insight comes the legal conception of the corporate structure as a mediating hierarchy model, in which the board of directors' role is to mediate among the team members to divide the profits.¹¹⁰

Thus far, proponents of this mediating hierarchy model have not focused specifically on the question of corporate disclosure to shareholders, or used this model to explain the origins of the current corporate law structure. Nonetheless, the mediating hierarchy model has obvious implications for disclosure to shareholders. Because directors are key to the corporate model, and because shareholders are only one among several constituencies that the board must consider, disclosure to the shareholders would seem to be relatively unimportant. Disclosure to the board is central and disclosure to all constituencies might be desirable. Disclosure to the shareholders, however, especially for any corporate governance purposes, would seem unnecessary and misguided.¹¹¹

C. The Real Origins of the Modern Scheme

The real story is much richer, more conflicted, and ultimately leads to an understanding of the states' role as considerably more moral than previously imagined. It suggests that the states made principled, ethical choices about the corporate disclosure schemes they adopted, and that the disclosure provisions of the federal securities acts usurped the states' historic role, a role the states discharged honorably. In general, states created their disclosure requirements primarily to protect present shareholders. In other words, they facilitated corporate governance. Unlike later federal reforms, the states were not concerned with market integrity or with protecting unsophisticated people who might become shareholders.¹¹²

819 (1999); Lawrence E. Mitchell, *Trust and Team Production in Post-Capitalist Society*, 24 J. CORP. L. 869 (1999); Edward B. Rock & Michael L. Wachter, *Waiting for the Omelet to Set: Match-Specific Assets and Minority Oppression in Close Corporations*, 24 J. CORP. L. 913 (1999); D. Gordon Smith, *Team Production in Venture Capital Investing*, 24 J. CORP. L. 949 (1999); Eric Talley, *Taking the "I" out of "Team": Intra-Firm Monitoring and the Content of Fiduciary Duties*, 24 J. CORP. L. 1001 (1999); Steven M.H. Wallman, *Understanding the Purpose of a Corporation: An Introduction*, 24 J. CORP. L. 807 (1999).

109. See Blair & Stout, *Introduction*, *supra* note 108, at 745.

110. See *id.* at 746.

111. See, e.g., Blair & Stout, *Team Production*, *supra* note 108, at 309 (noting directors' roles in a privately held company vs. a publicly held company).

112. This part of the Article often refers to people who might become shareholders and uses the term potential shareholders. These phrases mean individuals whose business

Victor Morawetz, the author of the preeminent nineteenth century treatise on corporate law, stated in 1886 that shareholders have a general common law right to inspect their corporation's books and financial records at any reasonable time for proper purposes.¹¹³ Morawetz observed that many states' general incorporation statutes also provided an inspection right.¹¹⁴ By the 1880s, states had only recently replaced special statutes, passed ad hoc by the legislature for each corporation, with general incorporation statutes.¹¹⁵ Before 1820, in at least one prominent state, the legislatures typically responded to the disclosure question by requiring corporations to make certain financial information available to the shareholders once each year, usually at the annual meeting.¹¹⁶

This statutory obligation was apparently in addition to the common law rule of general shareholder access.¹¹⁷ By 1830, state legislatures changed their views about the appropriate processes for mandating corporate disclosure. Legislatures began to require corporations to make financial information available continuously to their shareholders.¹¹⁸ This effectively memorialized the inspection rule that Morawetz described, but typically did not require corporations to make a formal report to shareholders at the annual meeting.

These general shareholder access rules demonstrate a clear policy: shareholders have a right to information about their company so that they may exercise their franchise intelligently.¹¹⁹ The earliest modern treatise writer, Morawetz, understood that shareholder power over a corporation is aggregate in nature, rather than being a power residing in each shareholder.¹²⁰ A shareholder majority has the power to bind the corporation.¹²¹ Shareholder power, however, is nearly exclusively reduced to the annual election of the corporation's directors. Directors

is not the buying and selling securities nor long-term investments in securities. Although this Article uses the term "*potential* investors," this Article recognizes that they may already own securities of other corporations.

113. See 1 VICTOR MORAWETZ, *A TREATISE ON THE LAW OF PRIVATE CORPORATIONS* § 473 (2d ed. 1886).

114. See *id.*

115. See JAMES WILLARD HURST, *THE LEGITIMACY OF THE BUSINESS CORPORATION IN THE LAW OF THE UNITED STATES 1780-1970* 56 (1970).

116. See JOHN W. CADMAN, JR., *THE CORPORATION IN NEW JERSEY: BUSINESS AND POLITICS 1791-1875* 319 (1949).

117. See *State ex rel. Rosenfeld v. Einstein*, 46 N.J.L. 479, 482-83 (1884).

118. See CADMAN, *supra* note 116, at 320.

119. See 6 SEYMOUR D. THOMPSON & JOSEPH W. THOMPSON, *COMMENTARIES ON THE LAW OF CORPORATIONS* § 4525, at 411-12 (Edward F. White ed., 3d ed. 1927).

120. See MORAWETZ, *supra* note 113, § 238.

121. See *id.* § 447.

have all corporate power, and shareholders' remedy for incumbent directors of whom they disapprove is to vote them out at the next annual shareholder meeting.¹²²

These approaches were not designed to protect creditors, securities markets, or potential investors. This does not mean, however, that these groups have been without legal protections. As Willard Hurst pointed out, for example, creditors used contract language, and their considerable bargaining power, to protect their investments when lending money to corporations.¹²³

Because secondary markets did not exist for the vast majority of corporations there was simply nothing for states to protect yet.¹²⁴ Protecting individuals who contemplate the purchase of securities is often simply a corollary of protecting the secondary markets; secondary markets cannot flourish if investors lack confidence in the securities they are considering purchasing. Potential investors are more likely to buy shares, and secondary markets are more likely to be healthy, if these potential investors are entitled to more information. But this virtue is, obviously, missing to the extent no secondary markets existed for states to protect.¹²⁵ Thus, the theory was to protect potential investors for the investors' own sakes, rather than to protect indirectly the secondary markets. The common law provided remedies against selling shareholders who committed fraud¹²⁶ and against corporations and promoters that lied to potential shareholders to sell shares.¹²⁷

Did the states' approach to corporate disclosure effect the ends the states desired? More precisely, did the rule of access, supplemented on occasion by a rule of required disclosure, enhance shareholders' corpo-

122. *See id.* § 237.

123. *See* HURST, *supra* note 115, at 54-55; *see also* ALFRED D. CHANDLER, JR., HENRY VARNUM POOR 205-225 (1956) (noting that large corporations such as railroads felt compelled to disclose corporate information to such influential business publications as *Poor's Manual*.)

124. *See id.* at 91. The New York Stock Exchange, the only prominent secondary market for American securities, began to address disclosure in 1866 and first imposed a disclosure requirement in 1900. *See id.*

125. *See generally* VINCENT P. CAROSSO, INVESTMENT BANKING IN AMERICA: A HISTORY 240-54 (1970). Public offerings of securities, in the modern sense, and the subsequent proliferation of the number of companies whose securities are traded in the secondary market, are post World War I developments. *See id.*

126. *See, e.g.,* Strong v. Repide, 213 U.S. 419, 429, 431, 434 (1909); Diamond v. Oreamuno, 248 N.E.2d 910, 912 (N.Y. 1969).

127. *See, e.g.,* Old Dominion Copper Mining & Smelting Co. v. Bigelow, 74 N.E. 653, 655, 659 (Mass. 1905); *cf.* Old Dominion Copper Mining & Smelting Co. v. Lewisohn, 210 U.S. 206, 216 (1908).

rate governance abilities? The traditional story denies that these approaches worked, but the true answer is that they did work, especially considering the specific role that shareholders played. Shareholders had to select the managers each year. The shareholders, however, were not allowed to manage the company themselves, not even at the most abstract level of setting general corporate policy. The corporation's charter set out, fairly specifically, the corporation's business; the directors and officers designed and implemented strategies to effect most profitably this described business.¹²⁸ The shareholders' task each year was to confirm or replace the managers. Perhaps most importantly, shareholders were not considered "principals" in the sense that modern agency law understands that term, which is a person who has the right to control an agent's performance.¹²⁹

The traditional story declares that states made the wrong choice when they moved away from required corporate disclosure to the access system.¹³⁰ This is because corporations were expected to resist inspection requests, which would lead to a significant rise in shareholder costs to exercise their inspection rights. Furthermore, an effective records inspection often requires exactly the sort of information that a required report furnishes, but which a shareholder often might not have, and might not know to ask about.¹³¹

The requirement that the corporation submit a report to its stockholders appears, at first blush, to be the preferable solution simply because it allows shareholders to be passive. But, these reports have many limitations. One such limitation stems from a common state requirement that

128. State statutes typically required corporate charters that specify the corporation's purposes and powers. In the late 1960s, legislatures amended these statutes to provide that corporations could list their purpose as engaging in any lawful business. *See, e.g.*, DEL. CODE ANN. tit. 8, § 102(a)(3) (1991) (adopted by 56 Del. Laws 50 (1967)). Long before this statutory change, state legislatures largely freed corporations from the burden of having to state their purposes explicitly. In 1940, a leading corporations textbook devoted more than 10% of its pages (158 out of 1286) to the question of corporate power, suggesting that the issue was important in corporate practice. *See* 1 E. MERRICK DODD, JR. & RALPH J. BAKER, CASES ON BUSINESS ASSOCIATIONS: CORPORATIONS 313-471 (1940). By 1970, the fourth edition of that casebook treated the problem in barely 1% of its pages (22 out of 1816). *See* WILLIAM L. CARY, CASES AND MATERIALS ON CORPORATIONS 32-34, 50-69 (4th ed. 1970). As early as 1948, though, another leading casebook confessed that "[a]t all events, when a true question of 'ultra vires' is raised under a modern charter, it is generally a proof of poor draftsmanship on the part of the incorporation lawyers." CASES AND MATERIALS ON THE LAW OF BUSINESS ORGANIZATION (CORPORATIONS) 46 (Adolf A. Berle & William C. Warren eds., 1948).

129. *See* RESTATEMENT (SECOND) OF AGENCY § 14C (1958).

130. *See* HURST, *supra* note 115, at 89-90.

131. *See id.* at 89.

corporations submit the report at the shareholder annual meeting.¹³² Admittedly, this is a logical requirement because shareholders vote for the corporation's managers at this annual meeting.¹³³ Although, most states required corporations to hold their annual meeting within the state of incorporation, this was often a considerable distance away, by nineteenth and early twentieth century standards, from where many corporations' shareholders lived. Furthermore, corporations' growing acceptance of shareholder proxies, well established by the turn of the century, diminished shareholder incentive to attend the annual meeting, as well as manager incentive to have shareholders attend.¹³⁴ Thus, the efficacy of required reports was limited because many shareholders would not, in fact, receive the information.

Another limitation is that many statutes apparently permitted corporations to report to shareholders orally, which is problematic for various reasons. Stockholders would surely be unable to apprehend detailed, nuanced, or complex information. Corporations could make unintentional, not to mention outright fraudulent, misrepresentations in an oral report. In either case, a shareholder would have great difficulty authenticating for purpose of litigation information provided orally.

Written annual reports would not have been of much more value. In the days before inexpensive, easy document duplication, statutory provisions requiring corporations to provide written reports generally meant that all of a corporation's shareholders had access to only a single copy of the report.¹³⁵ Presumably, each shareholder could make a copy during the time allotted for inspection. That power, however, might be of little practical use. Shareholders who did not attend the annual meeting would have to make inspection demands to see these written reports.

In effect, an annual report provision was merely an illusory means of supplementing a shareholder's common law inspection right. Shareholders who did not attend the annual meeting, and thus could only obtain a written report by exercising inspection rights, only benefited from this report requirement by having access to a particular form of report, which

132. See CADMAN, *supra* note 116, at 319.

133. See DODD AND BAKER, *supra* note 128, at 698, 721-22; see also CADMAN, *supra* note 116, at 319.

134. See 1 SEYMOUR D. THOMPSON, COMMENTARIES ON THE LAW OF PRIVATE CORPORATIONS § 875 (2d ed. 1908). For a description of the development of proxies in America, see Leonard H. Axe, *Corporate Proxies*, 41 MICH. L. REV. 38, 38-50 (1942).

135. This interpretation is buttressed by provisions in some states that required corporations to transmit written reports to each shareholder. See DODD & BAKER, *supra* note 128, at 698, 721-22.

few states required with any specificity.¹³⁶ Furthermore, to the extent that the annual report requirement supplanted inspection rights, shareholders depended entirely on management's convenience to utilize their inspection right; shareholders could inspect and copy important information only at the annual meeting, which management generally convened at a time and place of their choosing.

The role of state corporate law disclosure regulations became richer, though less linear, in the years following World War I. Floatation of new issues of securities increased. These new issuances tended to be common stock rather than debt, and they were more frequently marketed to individual investors of modest resources who were located throughout the country. For the first time, these floatations were effected by underwriting syndicates of investment bankers rather than by the issuing companies or single bankers. This change greatly increased the number of stockholders, which meant that more people were affected by the traditional state disclosure rules.¹³⁷ It also meant that secondary trading markets beyond the New York Stock Exchange became more prominent. The Curb Exchange, located at the very front door of the NYSE itself, and the regional exchanges, which extended all the way to the Pacific Ocean, became important.¹³⁸

This sea of change in corporate finance also meant that government found a new constituency that needed protection: potential investors. Such potential investors were located throughout the nation and, with the post-War economic boom in the United States, the number of such potential investors grew rapidly. The government needed to protect potential investors during initial issuance and in the secondary trading settings. Unlike most corporate creditors in prior eras, these potential investors were not sophisticated and did not have bargaining power to obtain favorable contract protections from issuers or selling shareholders.

The states responded to these changes by retaining their existing disclosure requirements. They did not see a need to change the system simply because more citizens became shareholders. Shareholders' role in corporate governance thus remained unchanged. The fact that there

136. See HURST, *supra* note 115, at 90.

137. See JONATHAN BARRON BASKIN & PAUL J. MIRANTI, JR., A HISTORY OF CORPORATE FINANCE 190 (1997) (stating that "the number of individuals owning common shares . . . increased from a mere half million in 1900 to two million in 1920 and to ten million in 1930.").

138. See ROBERT SOBEL, THE CURBSTONE BROKERS: THE ORIGINS OF THE AMERICAN STOCK EXCHANGE 172 (1970).

were more individual corporate shareholders did not change the appropriate level and method of giving them information so that they could fulfill their role. Willard Hurst and others argued that shareholders needed increased protection in this post-World War I era, because the nature of capital formation changed and because of the increased complexity of major corporations whose securities were being sold across the country. For the first time, corporations' business activities swept the nation, which concomitantly increased the scope of their internal management requirements. Shareholders, therefore, needed increased disclosure to understand the workings of these new corporations.¹³⁹

As the law and economics scholars point out, however, this argument ignores the effect of at least three kinds of constraints on corporate management which made increased disclosure to shareholders less necessary: the product market, which was becoming national in scope; the capital market, in which a small number of sophisticated investment bankers decided which corporations would and would not receive capital; and the market for the new middle managers which created incentives for them to manage efficiently.¹⁴⁰ More fundamentally, this argument ignores the conceptual role of shareholders in the life of the corporation. Shareholders annually vote for the directors for the ensuing year. In the normal course of events, shareholders can assume that at least a substantial proportion of the directors will seek reelection. Furthermore, shareholders generally may assume that these directors have done a creditable job in discharging their duties during the past year. In any event, the shareholders are not the ultimate principals. They are owners only in a residual sense and are not potentially active managers themselves.

The states responded to the potential investors' perceived needs by adopting two sorts of requirements. First, some states adopted provisions requiring corporations to make certain information publicly available by filing this information with the state.¹⁴¹ This requirement allowed current shareholders to have access to information. However, state legislatures enacted these provisions primarily to aid potential investors in making investment decisions, not to address corporate governance concerns. The second way that states responded to the changes in corporate capital formation was by adopting "Blue Sky" laws. Starting with Kansas

139. See HURST, *supra* note 115, at 89.

140. See ALFRED D. CHANDLER, JR., *THE VISIBLE HAND: THE MANAGERIAL REVOLUTION IN AMERICAN BUSINESS* 5-6, 11-12 (1977) (examining how changes in industry "permitted administrative coordination to be more profitable than market coordination").

141. See DODD & BAKER, *supra* note 128, at 727-28.

in 1911, states imposed these regulations to protect consumers and, to a certain extent, to encourage market integrity.¹⁴² Although state legislatures directed these regulations at issuers, these legislatures primarily intended to affect investment bankers and broker-dealers, who were the intermediaries of capital and the points of contact with potential investors. States certainly did not aim these regulations at current shareholders and did not intend to affect corporate governance.

From the 1929 stock market crash, through the ensuing Great Depression, the states responded minimally to questions of the appropriate level of corporate disclosure. They initially gave current shareholders information rights to ensure that the shareholders' limited corporate governance role would be effectively discharged. After World War I, some states included measures to protect potential investors, provisions that also enhanced market integrity. None of these changes, financial or legal, changed the conceptual role of shareholders in the management of corporations. Furthermore, states did not intend to rectify the corporate disclosure system through legal responses because they deemed that system to be appropriate already.

In light of the true, richer account of the development of state corporate law disclosure requirements, one can see that the federal government did not enact the securities acts to rescue the American economy from the incompetent and immoral states. Instead, Congress chose to enact these securities acts to resolve a different, though related, problem: the care and feeding of the national securities markets. Thus, the answer to the question of whether the states' disclosure system is a moral one is: yes. The key, again, is a proper understanding of the shareholders' role in the corporate form and the states' conception of the best way to enhance the performance of that role.

At the earliest day of the modern American business corporation, shareholders' primary function involved investing their capital in return for the right to receive an aliquot share of the enterprise's excess profits and, perhaps, some profit at a future date by selling that interest. The management of that collected capital was put in the hands of a few people. Those managers—in corporate law theory called directors—had, as a collective body, all of the corporate power. Their job was to manage this capital in the best economic interest of all of the shareholders, but the shareholders were not the ultimate managers. They did not set corporate goals, which were fairly specifically fixed in the corporation's initial charter. Shareholders also did not set the corporation's policy or

142. See LOSS & SELIGMAN, *supra* note 1, at 34-41.

strategy. The directors had to answer to the shareholders each year, but not the same way that an employee answers to an employer and not the same way that an agent answers to a principal. Rather, shareholders' status was something akin to the beneficiary of a trust. Although much writing has debunked the notion that a corporation is a trust for shareholders or creditors and that directors are trustees, the trust analogy is apt in this relatively narrow setting. Shareholders have a strong interest in how directors run their corporations and thus are the ultimate recipients of the business's gain. However, they are not charged with the firm's management. Even if shareholders act collectively, they may not, in classical corporate theory, run the corporation themselves. The core of this distinction is that shareholders only select managers—they do not delegate power to them that shareholders could retain for themselves.

States came to a relatively uniform approach to resolve the question of the information shareholders need to discharge their function of passing on the corporation's management. The amount of information the states considered adequate and the method by which corporations communicate that information to the shareholders is debatable. However, the states' position was certainly the product of a principled and moral choice about the appropriate division of authority within the business corporation and the concomitant mechanics of implementing corporate governance: these flow logically from that division of authority.

III. THE MORAL CLAIMS FOR EXPANDED STATE DISCLOSURE REQUIREMENTS

The point of much of the preceding discussion is that states initially created their corporate disclosure schemes with principled and ethical value choices about the appropriate allocation of corporate power between shareholders and directors.¹⁴³ This Article now argues that the two claims that commentators usually assert as moral grounds to support expanded state corporate law disclosure are ultimately inadequate.

A. Management Reform

The primary moral argument for expanded state disclosure requirements is that management can be reformed. There are two variations on this management redemption claim. The first argument asserts that managers who are required to disclose more information may come to see that their corporate strategies are wrongheaded and thus will want to

143. Cf. BERLE & MEANS, *supra* note 78, at 320, 325 (stating that corporate disclosure could be unethical if intended to affect the market price).

change them. The second version of the argument is that because of increased disclosure, other corporate constituencies will impose reform on the corporate managers.

This analysis of the possibility of management reform, however, begs an important question: whether corporate managers' ethical choices need to be reformed. Well-established corporate law posits that courts give corporate managers extremely broad discretion to set corporate policy. The discretion of corporate managers is restrained primarily when they have an interest that is adverse to the corporation.¹⁴⁴ Furthermore, managers must comply with the requirement that, whenever acting, they must use a fairly minimal degree of care.¹⁴⁵ Legislatures sometimes codify these requirements,¹⁴⁶ but otherwise constrain corporate managers' actions by regulating certain areas of action, such as bribes to foreign persons or environmental protection.¹⁴⁷ In the vast majority of decisions, corporate managers at every level of authority believe they are acting morally. In some cases, these reformers would have managers choose different courses of action. These alternative actions may be equally genuine and equally moral, but are rarely superior morally.

From the view of the state, if states have the power, indeed, the obligation, to impose the prevailing morality on corporate managers, then on what principled basis should the states choose something other than the morality of corporate managers? If managers select a course of action that they genuinely believe in and which is objectively moral, states should not impose a different course of action on the ground that it is more ethical and moral, than the one chosen by the managers. This approach allows states to impose safety obligations and other restrictions on corporate activity on the ground that contrary choices by managers are, ultimately, immoral.

1. Reform by Management

The first, and most salient, moral argument for expanding corporate disclosure is that it will lead to reform of corporate behavior by corporate managers, principally directors and senior management. Although this approach has been tried in several settings, it has often proved ineffective.¹⁴⁸

144. See, e.g., *Weinberger v. UOP, Inc.*, 457 A.2d 701, 710-11 (Del. 1983).

145. See, e.g., *Smith v. Van Gorkom*, 488 A.2d 858, 872-73 (Del. 1985).

146. See, e.g., MODEL BUS. CORP. ACT (1998).

147. See, e.g., Foreign Corrupt Practices Act, 15 U.S.C. § 13(a),(c)-(f) (1994); CERCLA, 42 U.S.C. § 9601 (1994 & Supp. 1998).

148. See, e.g., *Loudon v. Archer-Daniels-Midland Co.*, 700 A.2d 135, 143 (Del. 1997).

Except in the unusual case of genuinely illegal corporate activity, disclosure will not typically lead to corporate reform. The vast majority of corporate managers believe that, daily they make moral choices for the corporation, its shareholders, other corporate constituencies such as suppliers, customers, employees, neighbors, the society in which the corporation does business, and of course the managers themselves.

Corporate managers, like all other humans, do not always act in accordance with the perfect economic rationality predicted by classical economic theory. The study of this non-rational behavior is systematized by behavioral economics. A subset of this inquiry focuses its attention on the non-rational behavior of organizations and their managers. Recently, Donald Langevoort culled institutional organization theory literature and suggested ways that managers' non-rational perceptions may, systematically and persistently, skew organizational behavior.¹⁴⁹ Langevoort suggested that the institutional organization theory literature would be "useful[] in a wide range of legal settings, and thereby prompt a research agenda to build on" that literature.¹⁵⁰

For Langevoort, a central quality of corporate management is that, even in relatively small corporations, the senior managers lack first-hand knowledge of the business operations. Rather, front-line supervisors and middle managers have access to substantial important information that must be sent selectively to senior managers.¹⁵¹ The less senior managers often send information upward because this information is significant or unusual, or both.¹⁵²

Langevoort identified four persistent biases, in which he convincingly

The *Loudon* court held that "'a [corporate] board is not required to . . . draw legal conclusions implicating itself in a breach of fiduciary duty from surrounding facts and circumstances prior to a formal adjudication of the matter.'" *Id.* (quoting *Stroud v. Grace*, 606 A.2d 75, 84 n.1 (Del. 1992)). The federal securities acts and the cases interpreting them primarily focus on disclosure of criminal convictions and, possibly, criminal acts that do not involve convictions. See RICHARD W. JENNINGS ET AL., *SECURITIES REGULATION* 225-31 (8th ed. 1998). As on the corporate side, the courts have often shied away from requiring disclosure under the securities laws of "bad" things that are not illegal. See *id.*

149. See Donald C. Langevoort, *Behavioral Theories of Judgment and Decision Making in Legal Scholarship: A Literature Review*, 51 VAND. L. REV. 1499 (1998); Donald C. Langevoort, *Organized Illusions: A Behavioral Theory of Why Corporations Mislead Stock Market Investors (and Cause Other Social Harms)*, 146 U. A. L. REV. 101 (1997) [hereinafter Langevoort, *Organized Illusions*]; Robert B. Thompson, *Securities Regulation In An Electronic Age: The Impact of Cognitive Psychology*, 75 WASH. U. L.Q. 779 (1997). For citations to the institutional organization theory literature, see Langevoort, *Organized Illusions*, *supra*, at 103 n.6, 104 n.10, 108 n.20, & 130 n.101. But cf. *id.* at 109 n.23.

150. Langevoort, *Organized Illusions*, *supra* note 149, at 108 (citation omitted).

151. See *id.* at 119-26.

152. See *id.* at 136.

argued, result in managers' strict adherence to a course of action against objective contrary evidence.¹⁵³ First, cognitive dissonance may impede corporate managers, subsequent to analyzing a business situation and committing the corporation to a particular course, from admitting that flaws existed in either the original analysis or commitment, or that subsequent events made the analysis or commitment suboptimal.¹⁵⁴

In a second and related bias, managers exhibit a persistent tendency against re-analyzing new information because of intellectual and emotional limits on their ability to re-process information continually.¹⁵⁵ Managers tend to view new data as confirming, if at all possible, the original analysis.¹⁵⁶ This predilection is exacerbated when managers work in teams because teams simplify the results of their analysis to reach an agreement more easily and then implement a course of action.¹⁵⁷ Consequently, the bias against re-analyzing information becomes increasingly problematic because the original analysis is more simplistic than the original data warranted.¹⁵⁸

The third bias is that managers are often systematically overoptimistic about their managerial skills.¹⁵⁹ This bias leads managers to discount the potential adverse effects of new data or data that is inconsistent with their original analysis.¹⁶⁰

The tendency of managers to identify their own preferences and values with optimum corporate policy is the fourth, and most germane of Langevoort's persistent biases.¹⁶¹ To the extent that senior managers of a corporation exhibit this bias, corporate policy in the largest sense, is established.¹⁶² Langevoort suggests that the pervasiveness of a particular belief throughout a corporation's management structure is indicative of whether that belief is objectively supported or is more likely a senior managers' self-serving bias.¹⁶³ If a belief is not widely shared throughout the corporation, and therefore reflects the senior management group's shared bias, the senior group's power is usually sufficient to make the senior group's belief official corporate policy that must be implemented

153. *See id.* at 133.

154. *See id.* at 142-43.

155. *See id.* at 135-39 (defining the bias against revision).

156. *See id.* at 136-37.

157. *See id.* at 137.

158. *See id.* at 137-39.

159. *See id.* at 137.

160. *See id.* at 139-41.

161. *See id.* at 143-46 (discussing the self-serving belief bias).

162. *See id.* at 145.

163. *See id.*

by other managers who do not share the bias.¹⁶⁴

The conditions that allow these biases to persist are also important. After all, a central consequence of a strong market system is that rational economic actors will drive non-rational economic actors, (i.e. firms, and individuals that form policy) out of business. If this is true, biases are interesting as pathology, but nothing more.

Donald Langevoort identifies both economic and psychological theories that hypothesize as to why these biases might persist for significant periods.¹⁶⁵ Economically, Langevoort recognizes that firms often compete in imperfect markets,¹⁶⁶ which arise because of one company's competitive success.¹⁶⁷ Because of one company's success, that firm is less likely to respond to forces of the product, capital, and managerial markets.¹⁶⁸ Thus, market imperfections permit firms with biases to thrive for substantial periods before market forces respond.¹⁶⁹ Further, as firms and markets become increasingly complex, there will be fewer instances in which a particular course of action is deemed non-rational.¹⁷⁰ Therefore, managers and outsiders may have difficulty perceiving whether a decision is the product of rationality or non-rationality.¹⁷¹

As to the psychological bases for bias persistence, Langevoort suggests that bounded rationality focuses a firm on tasks it has historically done well.¹⁷² Langevoort also suggests that a consistently optimistic bias can have the beneficial effect of encouraging firms and employees to take risks, which if not carried too far, can help bring about economic success.¹⁷³

The upshot of Langevoort's observations, in the context of corporate morality, is that managers are unlikely to reform their behavior when they visibly fail to act in the corporation's best interest.¹⁷⁴ Instead, managers tend to ignore objective indications that their actions are inappropriate and tend to recharacterize this failure in self-serving terms.¹⁷⁵

164. See *id.* At a relatively theoretical level, this situation is the kernel for the humor in any number of *Dilbert* comic strips.

165. See *id.* at 149-51.

166. See *id.* at 149-52.

167. See *id.*

168. See *id.* at 150-51.

169. See *id.* at 149-52.

170. See *id.* at 151.

171. See *id.* at 151-52.

172. See *id.* at 152.

173. See *id.* at 153-56.

174. See *id.* at 153-54.

175. See *id.* at 154.

The reform efforts undertaken by Caremark International, Inc. provide a notable and anecdotal example of the intractability of management reform through mandatory corporate disclosure. C.A. Lance Piccolo, a strong-willed chief, ran Caremark's two business lines.¹⁷⁶ The less important line provided managed care services to health professionals. These services included acquiring or providing business services to physician practice groups.¹⁷⁷ Caremark's more important line of business provided outpatient goods and services.¹⁷⁸ These goods and services, usually referred to as "home health care," included physical and rehabilitative therapies, and therapeutic drugs for a variety of patient needs.¹⁷⁹

The home health care industry was profitable and ready to explode in importance and profitability in the early years of the Clinton administration.¹⁸⁰ This industry, however, is also subject to clear and serious abuses.¹⁸¹ The root of the problem is the inability of private and governmental entities that typically pay for home health care services to exert sufficient oversight in the home setting.¹⁸² By contrast, in a hospital setting, health professionals and hospital administrators can accurately monitor whether goods and services are needed, actually provided, and properly charged for.¹⁸³ Typical abuses include charging for goods and services that were never provided and overcharging for goods and services actually provided.¹⁸⁴ Another common abuse involves various forms of kickbacks to induce health care professionals either to prescribe unnecessary goods and services to patients or to steer patients who do need home health care to the company's products.¹⁸⁵

Caremark contracted with hospitals and health care providers to render advice, consult, do research, and monitor patients receiving Caremark goods and services in their homes.¹⁸⁶ This helped Caremark im-

176. See Ron Stodghill II, *A Mea Culpa—and a Comeback?*, BUS. WK., July 3, 1995, at 33.

177. See *id.*

178. See *id.*

179. See *In re Caremark Int'l, Inc. Sec. Litig.*, No. 94C4751, 1996 U.S. Dist. LEXIS 8751, at *2 (N.D. Ill. June 21, 1996); *In re Caremark Int'l, Inc. Derivative Litig.*, 698 A.2d 959 (Del. Ch. 1996).

180. See Linda Himelstein, *Is Fraud Poisoning Home Health Care?*, BUS. WK., Mar. 14, 1994, at 70-71.

181. See *id.* at 70.

182. See *id.*

183. See *id.*

184. See *id.* at 72.

185. See *id.*

186. See *In re Caremark Int'l, Inc. Derivative Litig.*, 698 A.2d 959, 962 (Del. Ch. 1996).

prove its goods and services, and thus to retain its position as the leading home health care provider in an increasingly competitive market.¹⁸⁷ The people and entities with whom Caremark contracted, however, also had the power to prescribe or recommend Caremark's goods and services; this created the possibility that at least some of the contracts that Caremark entered into were actually kickbacks, rather than legitimate contracts for advice, consultation, research, or monitoring.¹⁸⁸

Caremark knew the dangers of these contractual relationships.¹⁸⁹ Thus, in 1989, Caremark promulgated its *Guide to Contractual Relationships* that went through five editions by 1994, to guard against its 7000 employees and 90 branch offices from entering into disguised kickback arrangements.¹⁹⁰ Caremark also revised its standard contracts to comply with some narrow safe harbor regulations adopted by the Department of Health and Human Services in July 1991.¹⁹¹ Caremark also had an Ethics Committee of its board of directors and had an in-house audit department, which ensured Caremark's compliance with the law and Caremark's ethics policies.¹⁹²

Nonetheless, in late 1991, the Department of Health and Human Services began investigating Caremark's practices, which in turn led the Department of Justice and a number of states to launch investigations of their own.¹⁹³ In response to these investigations, Caremark discontinued its payments to health care professionals who provided monitoring services.¹⁹⁴ Caremark's home office increased its oversight of the branch office actions and increased its employee training programs.¹⁹⁵ Caremark's board continued to evaluate the company's actions by receiving reports from in-house and outside legal counsel.¹⁹⁶ The board also commissioned at least one assessment from its financial auditor that concluded that there were no material weaknesses in the internal legal and ethical

187. *See id.*

188. *See id.*

189. *See id.* at 963 ("Although there is evidence that inside and outside counsel had advised Caremark's directors that their contracts were in accord with the law, Caremark recognized that some uncertainty respecting the correct interpretation of the law existed.").

190. *See id.* at 962-66. "Each version of the Guide stated . . . that no payments would be made in exchange for or to include patient referrals." *Id.* at 962.

191. *See id.* at 962.

192. *See id.* at 963.

193. *See id.* at 962.

194. *See id.*

195. *See id.* at 962-63.

196. *See id.*

auditing structure.¹⁹⁷

In the fall of 1994, after a four-year investigation, federal indictments of Caremark were handed up.¹⁹⁸ Within twenty-four hours, one of Caremark's shareholders filed the first of five shareholder derivative actions in the Delaware Court of Chancery.¹⁹⁹ About a year later, a number of insurance companies threatened Caremark with litigation on the ground that Caremark's home health care billing practices defrauded them of money.²⁰⁰ In September 1996, two years after the first indictment and six years after the government's first investigation, Caremark settled the last of these disputes.²⁰¹ Caremark paid approximately \$164 million to settle the federal and state government claims and paid the insurance companies approximately \$98 million.²⁰² Caremark paid \$262 million in total, which does not include the attorney fees and other associated costs that Caremark spent to investigate, litigate, and settle these claims.²⁰³ Although Caremark did not settle the shareholder derivative suits with monetary payments to their shareholders, Caremark paid just under \$1 million to the shareholders' attorneys.²⁰⁴

Caremark's story is germane to this Article because, throughout all the investigations and indictments, the federal government never indicted or implicated Caremark's senior officers or directors.²⁰⁵ In fact, one specifically negotiated provision of the governmental settlement was that "no senior executive of Caremark participated in, condoned, or was willfully ignorant of wrongdoing."²⁰⁶ In the shareholder derivative action, Chancellor Allen also found that the Caremark board had no knowledge of any wrongdoing, nor did it fail to exercise sufficient oversight over the company's actions.²⁰⁷ Yet, the board clearly knew about, indeed, established as corporate policy, the business practices that, when they were abused in predictable ways by lower level employees, cost the company a

197. *See id.* at 963.

198. *See id.* at 960.

199. *See id.* at 964 (noting that the original complaint alleged that Caremark's directors "breached their duty of care by failing to supervise the conduct of Caremark's employees").

200. *See id.* at 966.

201. *See id.* at 965-66.

202. *See id.* at 965 n.10, 966.

203. *See id.*

204. *See id.* at 965 n.13, 972.

205. *See generally id.* at 960-72.

206. *Id.* at 965 (quoting Chancellor Allen's opinion, not the governmental settlement itself).

207. *See id.* at 971-72.

quarter of a billion dollars.

The Securities Exchange Act of 1934 required Caremark to disclose, at least quarterly, all material information about the company. This reporting requirement mirrors the proponent's argument that expanded state disclosure should produce management reform: where a corporation's management does not act criminally, but nonetheless acts in a way that is distinctly deleterious to the corporation and its shareholders. The proponents' argument is at odds with Donald Langevoort's arguments pertaining to the systematic and persistent non-rational economic behavior of businesses. Clearly, the Caremark management did not reform itself.

Caremark's story identifies qualities that are consistent with Langevoort's suggestions. Two typical biases suggest themselves as having played a part in the Caremark disaster. First, the managers' systematic over-optimism may have led the managers to believe that they and Caremark would not engage in unethical or illegal practices, barring the inevitable, isolated instances that any corporation of moderate size would encounter. Furthermore, such optimism may have led the managers to believe that Caremark would not be subject to investigation or ultimately face substantial settlement amounts.

Second, six years elapsed from the beginning of the first investigation to the end of the last settlement.²⁰⁸ The senior managers' cognitive dissonance likely had a substantial role in the business practices that led to the investigations and notable length of those investigations. Once the managers analyzed the business setting of the home health care industry, the managers would naturally be reluctant to re-analyze it. More precisely, the Caremark managers may have rejected new evidence suggesting that their original analysis was wrong or that circumstances warranted a new approach. Cognitive dissonance might have easily continued during the investigations and settlements. For example, Caremark made several reforms in light of the investigations.²⁰⁹ Because of these reforms, the managers might have rejected new developments that criticized the reforms or proposed further measures. Instead, the managers probably interpreted each new development as supporting their initial reaction to the investigations.

These biases could have persisted long enough to exacerbate greatly Caremark's problems. As the market leader in home health care, Care-

208. *See id.* at 960-72.

209. *See id.* at 962-63.

mark enjoyed considerable competitive success.²¹⁰ Caremark, therefore, presumably enjoyed higher profit margins than its competitors. To the extent that consumers viewed Caremark's products and services as lacking fungibility, product market forces would be diminished. Capital markets did not exert constraint on Caremark because Caremark had no need for new capital. During the investigations, Caremark's stock price fell precipitously, causing commentators to cite Caremark as a potential takeover target.²¹¹ Nonetheless, during the investigative years, Caremark's capital restrictions did not dictate the business or litigation strategy the company adopted.²¹² Eventually, market forces caught up with Caremark.²¹³ After the settlements, Caremark chose to end its involvement with home health care and focus on operating physician practice groups.²¹⁴ To effect this change, Caremark sold its assets rather than tap the capital markets.²¹⁵ Presumably, Caremark's depressed price was a significant constraint in making that decision.

The persistence of Caremark's biases may have resulted from forces other than blunted market constraints that caused serious corporate harm. The home health care industry only recently became important to medical care. The Department of Health and Human Services (DHHS) began to investigate the home health care industry soon after the industry became important to medical care. Because of the novelty of the industry and unpredictability of DHHS decisions, Caremark did not have a clear algorithm for responding to these other forces, thus allowing Caremark managers' biases to mask optimal choices. Further, Caremark's business approach was exactly what made it the leading home health care provider. Bounded rationality worked in Caremark's favor for a considerable time by locking in the successful analysis and approach.

Finally, Caremark's managers' optimism over the possibility of Caremark's vindication might have led Caremark to stand firm against the investigations. These managers may have thought that they would be as successful in that endeavor as they were in their business approach. In sum, Caremark's senior managers could easily have had systematic biases that were deleterious to Caremark's best interest. These biases could have persisted sufficiently to have caused Caremark exactly the problems

210. See Gene G. Marcial, *A Slew Of Suitors Wants To Shower Caremark With TLC*, BUS. WK., Oct. 18, 1993, at 90.

211. See *id.*; see also Stodghill, *supra* note 176, at 33.

212. See Stodghill, *supra* note 176, at 33.

213. See *id.*

214. See *id.*

215. See *id.*

it suffered.

Although this analysis is conjectural, another telling fact needs emphasis. As noted previously, after settling the litigation, Caremark moved away from home health care to emphasize its other business line, managing and servicing physician practice groups. Caremark's CEO, C.A. Piccolo, commented on the final settlement, stating that "[t]here are no drinks or cheers . . . I just feel genuinely bad that it happened, and I'm glad it's over."²¹⁶ This statement is less reflective of the past than on future events. This attitude is typical among successful as well as unsuccessful businesspersons. This attitude does not support the notion that managers who believe their actions are ethical and legal will "reform" themselves easily in reaction to events that suggest change. Therefore, corporate disclosure to shareholders will not result in managers reforming themselves.

2. Reform of Management

The second principal management reform argument is that increased disclosure will lead others to reform managers. This is unlikely to happen in either public or closely held corporations with any great consistency.

In the publicly held company, much of this discussion is moot because the federal securities laws mandate extensive disclosure. If that fifty-year-old disclosure system is an accurate indicator of what would happen if a similar scheme were imposed by state law on closely held companies, the reform argument falls completely away. In fact, other groups have not, by and large, reformed management because of required disclosure obligations.

In the public company, shareholdings are typically dispersed. Thus, shareholders, as a group, do not exert effective control over the management of the company, although, two other groups are capable of exerting control over management and, hence, "reforming" the managers. Institutional shareholders, a subset of the general shareholders, are one group that is capable of exerting control.²¹⁷ Institutional shareholders can

216. *Id.*

217. On institutional investors and their limitations, see Jayne W. Barnard, *Institutional Investors and the New Corporate Governance*, 69 N.C. L. REV. 1135 (1991); Bernard S. Black, *Agents Watching Agents: The Promise of Institutional Investor Voice*, 39 UCLA L. REV. 811 (1992); Bernard S. Black, *The Value of Institutional Investor Monitoring: The Empirical Evidence*, 39 UCLA L. REV. 895 (1992); Helen Garten, *Institutional Investors and the New Financial Order*, 44 RUTGERS L. REV. 585 (1992); and Mark J. Roe, *A Political Theory of American Corporate Finance*, 91 COLUM. L. REV. 10 (1991).

avoid the rational apathy that keeps small shareholders inactive and therefore gain enough from their activism to make the costs of monitoring and reforming management worthwhile. Further, institutional investors' inability to liquidate holdings in any particular company makes them more likely to spend their resources to influence management, although they do not capture all the gains from their efforts.

Even in the public company context, however, strong counterarguments prevail. Institutional investors often remain passive, although there are incentives to becoming active. The free rider problem and rational apathy may simply be too much to overcome. Despite the promise of institutional shareholder activism, many institutional investors also succumb to the temptation to remain passive to curry management's favor. In effect, institutional investors are co-opted by a system that gives institutional investors preferential treatment to consult with management, in return for the shareholders' blanket support of the incumbents.

The promise of institutional investor activism has a dark side for other shareholders as well. The views and incentives of institutional shareholders may not match a majority of individual shareholders' views. The interests of the largest and most active institutional shareholders, public pension funds, are often established by the political nature of trustee appointments. Institutional investors typically have a short-term focus as compared to individual investors, which places the optimal corporate policy for institutional shareholders at odds with that of individual shareholders.

Additionally, institutional investors do not, by virtue of their size, beneficiaries, or activism, possess special expertise in advising corporate management. In fact, many institutional investors contract-out their corporate activism to advisory services, such as the Lens Group. This further attenuates the link between corporate governance and the majority of shareholders. Finally, even if institutional investors capture corporate management functions, institutional investors will simply reproduce the disclosure problem at a different level. If institutional investors influence management, and if the goal of mandatory corporate disclosure is to reform those who manage corporations, institutional investors should be required to disclose information similar to that disclosed by corporate managers.

If past conduct is any guide to the future, corporate managers in public companies are less likely to be reformed by shareholders than they are by another group interested in corporate affairs: financial analysts, and journalists that typically report about consumer reactions. Financial analysts and journalists are capable of catalyzing changes in corporate

attitudes by exposing business practices that are perceived as immoral by the general public but which management honestly believes is proper.²¹⁸ The very nature of corporate policies often makes it impossible to know whether a corporation's changed views come in response to pressure from analysts and journalists. The best interest of the corporation is served by claiming that the new policy was originally intended or that the original policy was a rough proposal or trial balloon.

One recent example suggests that analysts and journalists have a strong affect on corporate policies. In August 1999, Amazon.com, Inc. announced that it would post on its web site the most popular purchases, grouped by purchasers in geographic areas, corporations, and universities.²¹⁹ Almost immediately, newspapers reported that security experts, customers, and employers of customers objected to these "purchase circles."²²⁰ The complainants objected because Amazon.com used data mining to compile the lists, which they argued was an invasion of privacy and could allow competitors of the companies profiled to infer strategic policy. These are, at bottom, ethical concerns. Amazon.com, Inc. quickly retreated from its original plan and now allows individuals and companies to opt out of its purchase circles.²²¹

In sum, the group that is most often responsible for bringing about change in corporate management, journalists and financial analysts, cannot spur change solely by using information that is disclosed under the federal mandatory disclosure requirements. Journalists and financial analysts have other channels and sources of information that are more germane to the process of corporate cultural change. Thus, in the public company setting, mandatory disclosure may protect capital markets, but nonetheless does nothing to enhance corporate governance. In sum, if the existing mandatory disclosure under federal securities laws is any guide as to whether non-managers are capable of reforming corporate management through disclosure requirements, it is unlikely that such reform will materialize.

Private corporations would not fare any differently by having imposed

218. Analysts and journalists are the primary agents of exposing corporate behavior that is flat-out illegal. These groups first exposed, for example, Equity Funding, Home-stake Oil, ZZZZ Best, and David Begelman.

219. See *Amazon's Purchase Circles Guide Shoppers*, SEATTLE TIMES, Aug. 20, 1999, at C1.

220. USA Today first broke this story. See Janet Kornblum, *Amazon.com Feature Fuels Privacy Fears*, USA TODAY, Aug. 26, 1999, at 1A.

221. See, e.g., George Anders & Lisa Bransten, *Amazon to Let Firms Withhold Data on Habits*, WALL ST. J., Aug. 27, 1999, at B6; David F. Gallagher, *Amazon Moves to Ease Worry About Privacy of Customers*, N.Y. TIMES, Aug. 30, 1999, at C1.

upon them a more elaborate system of corporate disclosure. If the shareholdings are widely dispersed, which is an unusual, but not impossible situation, then reform of management by others seems remote. The shareholders must unite to forge enough power to reform management; however, free rider and collective action constraints dampen that possibility. Most privately held companies lack the size to be noticed by financial analysts or other journalists, although there are exceptions.²²²

For the bulk of private corporations, the identity of management and shareholders means that enhanced corporate disclosure is otiose. Corporate governors possess all of the information that pertains to corporate operations because they manage the company. In the vast majority of privately held corporations, ownership and control are not separated. Therefore, increased disclosure is unnecessary, except to give more information to the silent shareholders, if any.

In many private corporations, however, some shareholders have sufficient power to control the corporation, but do not exert their power. These passive but controlling shareholders, such as venture capitalists or founding families, cede power to management albeit retaining residual power. These shareholders need information to exercise their corporate governance powers intelligently. Like corporate creditors in Hurst's view, however, these shareholders typically protect their power with contracts rather than relying upon corporate law schemes.²²³

In public and the private corporations, it is very unlikely that non-managers can reform management through enhanced state corporate disclosure laws.

B. Investor and Market Protection Motivations

The potential for better investment decisions by investors and the concomitant improvement of secondary securities markets is the second primary moral argument for increased state corporate disclosure requirements. This is a totally fatuous argument. For public corporations, such a state disclosure scheme would be duplicative. More theoretically, many scholars have pointed out that modern portfolio principles strongly suggest that investors who expend resources in obtaining and analyzing company-specific information drive up their costs without increasing re-

222. Large privately held companies include Mars, Cargill, and Gallo. *Forbes* magazine recently reported that 77 of the top 500 privately held companies must make periodic reports under the Securities Exchange Act of 1934. *500 Biggest Private Companies*, *FORBES*, Dec. 13, 1999, at 167.

223. See PAUL A. GOMPERS & JOSH LERNER, *THE VENTURE CAPITAL CYCLE* 130 (1999).

turns.²²⁴ In the macroeconomic analysis, which focuses on society's best economic interest, rather than that of particular potential investors, scholars posit that the SEC's mandatory disclosure system is largely outdated if it was ever, in fact, dated. Public corporations spend millions each year complying with mandatory periodic disclosure obligations of the Securities Exchange Act. Multiple studies have shown that information contained in security disclosures is either irrelevant to investors or impounded in the stock's market price before the disclosures are made. This is because financial analysts discover, intuit, and calculate much of the important information before such information is filed with the SEC.²²⁵

In the non-reporting company setting, increased state corporate disclosure is unlikely to lead to better investment decisions by investors. Investment is typically unmediated; investors deal directly, or nearly so, with the corporation's principals, perhaps through lawyers or investment bankers who are charged with finding investors. Investors can use their contract bargaining power to compel disclosures. Investors that do not obtain satisfactory disclosure can simply choose not to invest.

An investor who already owns stock in a non-public company will likewise find increased corporate disclosure unhelpful because of the illiquidity of the investment. Although the investor is a shareholder, and is thus subject to the preceding arguments about whether corporate governance is served better by increased disclosure, the question whether to continue to invest is largely moot. The illiquid nature of close corporations means that selling is simply not a viable option for most investors.

IV. A MORAL DEFENSE OF STATE CORPORATE LAW DISCLOSURE

The current system of state corporate law disclosure is defensible on moral grounds. The root of this assertion is that telling the truth is moral and the current disclosure system is truthful about the relationship between shareholders and corporate managers. This morality argument accurately reflects the status quo in the corporate world. As discussed previously, it is simply not true that increased corporate disclosure is significantly transformative or instrumental. At its most potent, disclosure is incremental in effecting change and is supplemented by other ac-

224. See, e.g., RONALD J. GILSON & BERNARD S. BLACK, *THE LAW AND FINANCE OF CORPORATE ACQUISITIONS* 135-36 (2d ed. 1995).

225. See *id.* at 136-37; see also Jason Anders & Carrie Lee, *Web Site Posts the Earnings Estimates that Most Sources Will Only Whisper*, WALL ST. J., Oct. 19, 1998, at B15 (discussing the phenomenon of "whisper numbers," which are earnings numbers that corporations selectively disclose to analysts in advance of a public announcement).

tions such as notions of social policy and ferreting out of wrongdoing in spite of, rather than because of, required disclosure to shareholders.

It is more moral to be accurate than disingenuous about the capacity of corporate disclosure to effect changes in managerial actions. The truth is that shareholders have ceded, both theoretically and practically, their money, and control over it, to the board of directors in return for the expectation of financial gain.

The information required by states reflects this division of power. Shareholders typically receive annual financial statements. The financial statements should reflect modern accounting principles to reflect the financial condition of the enterprise. There are two examples of such recent changes. First, the statement of cash flows replaced the older statement of changes in financial position in the late 1980s.²²⁶ Second, accountancy is grappling with the appropriate method of disclosing the value of stock options granted to senior managers.²²⁷

Shareholders are typically entitled to disclosure of any significant self-dealing by senior managers. This is true even when shareholder consent is not required or resorted to by managers to immunize such a transaction from shareholder attack.²²⁸ Finally, corporations must disclose information about proposed fundamental changes to shareholders. This disclosure reflects the division of power between shareholders and managers because managers cannot complete a fundamental change without shareholder approval.²²⁹

The states' corporate disclosure systems reflect the truth about corporate decisionmaking power and the possibility of change. Those who support a different system of disclosure would change the dynamic of power distribution, which is not desirable. Furthermore, any attempt to change the dynamic of power distribution via changing the disclosure regimen will not be effective. Worse, it presumes that the current system is immoral although the present state of the relationship between shareholders and managers reflects that this system is highly ethical.

226. See FINANCIAL ACCOUNTING STANDARDS BD., STATEMENT OF FINANCIAL ACCOUNTING STANDARDS NO. 95: STATEMENT OF CASH FLOWS 1 (1987).

227. See FINANCIAL ACCOUNTING STANDARDS BD., STATEMENT OF FINANCIAL ACCOUNTING STANDARDS NO. 123: ACCOUNTING FOR STOCK-BASED COMPENSATION (1995).

228. See DEL. CODE ANN. tit. 8, § 144 (1991); *Malone v. Brincat*, 722 A.2d 5, 9 (Del. 1998).

229. See DEL. CODE ANN. tit. 8, §§ 242 (amendment of certificate of incorporation), 251 (merger), 271 (sale of assets), 275 (dissolution) (1991); MODEL BUS. CORP. ACT §§ 10.03 (amendment of articles of incorporation), 11.02 (merger), 12.02 (sale of all or substantially all assets), 14.02 (dissolution) (3d ed. & Supp. 1998/99).

V. CONCLUSION

For over seventy years, the dominant conception of state corporate disclosure obligations declared that states were recalcitrant, unethical actors. By enacting the New Deal securities acts, the federal government rescued the American capital markets by imposing necessary disclosure requirements. This interpretation is wrong both in its understanding of the origins of the state regulatory scheme and in the moral implications of those origins. In truth, the states made completely rational and highly ethical choices when they decided on the levels of and methods of appropriate corporate disclosure. Therefore, morality-based arguments for increased state law corporate disclosures do not have a superior claim to morality. Furthermore, they are unlikely to be effective.

